

Chapter 1

THE NEED FOR TAX REFORM: BACK TO BASICS

The present income tax is badly in need of fundamental simplification and reform. It is too complicated, it is unfair, and it interferes with economic choices and retards saving, investment and growth.

In a real sense, the U.S. income tax has grown without any conscious design or overall planning since it was enacted in 1913. It was originally imposed at low rates and applied to fewer than 400,000 individuals with very high incomes. The need to finance World War II and expanded non-defense expenditures turned the individual income tax into a levy paid by most Americans. Tax rates were increased during World War II, and at their peak individual income tax rates reached 94 percent. The original income tax had serious flaws, and while some of these have been corrected over time, others have grown worse. With over 90 million individual tax returns now being filed, it is important to address these problems.

It is one thing to decide to tax "income," and quite another to decide how to define taxable income. If inadequate attention is devoted to establishing a uniform and consistent definition of income, some sources and uses of income will escape tax, and others will be taxed twice, as in the United States. The result may or may not be a simple tax system, but it is certain that the tax system will contain inequities and interfere with the economic behavior of taxpayers.

The U.S. income tax is not used simply to raise revenue. Instead, it is used to subsidize a long list of economic activities through exclusions from income subject to tax, adjustments to income, business deductions unrelated to actual expenses, deferral of tax liability, deductions for personal consumption expenditures, tax credits, and preferential tax rates. In some cases, deviations from a comprehensive definition of income originated in incomplete understanding of the concept of income or in outmoded ideas about the proper fiscal relationship between the Federal Government and state and local governments. But whatever its origin, in many cases bad public policy has become accepted -- virtually enshrined -- as appropriate.

For seven decades, the Treasury Department has fought to protect Federal revenues and the fairness and economic neutrality of the tax system from those seeking to create and exploit gaps and inconsistencies in the definition of taxable income. As loopholes have been discovered or created, exploited, and then plugged, techniques of tax avoidance have become increasingly sophisticated and the complexity of the income tax has grown, in a never-ending cycle.

The resulting tax system is both unfair and needlessly complex. Moreover, it interferes with economic behavior and, thus, prevents markets from allocating economic resources to their most productive uses. Perhaps worse, the complexity and inequity of the tax system undermine taxpayer morale -- a valuable, yet fragile, national asset and a prerequisite for a tax system based on voluntary compliance.

During the past year, the Treasury Department has undertaken a thorough review of the U.S. tax system. The object has been to determine how to reduce the complexities, inequities, and economic distortions in the tax system and make it more conducive to economic growth. Although the present report was prepared internally by the Treasury Department, it draws heavily on a vast national storehouse of knowledge about the tax system and its effects on the economy. The report also reflects information, views, and concerns which the Treasury Department received from taxpayers in the course of public hearings, meetings, and discussions, and in correspondence and in more formal written statements.

The Federal Income Tax in 1954

To understand better the need for tax reform, it is useful to compare our present income tax system with the one that prevailed in the late 1950s, after enactment of the 1954 Internal Revenue Code. Though the 1954 income tax system exhibited some serious problems, it was relatively simple, it was more nearly neutral toward many economic decisions, and most citizens probably thought it was reasonably fair.

Today the American economy is far more complex than it was 30 years ago. The financial affairs of the typical American family are far more complicated than in previous generations. Ownership of both financial and nonfinancial assets is more widespread and varied. Families have a greater quantity and variety of income, both taxed and untaxed. Business transactions are more complicated, financial intermediation is more highly developed, and taxpayers are more sophisticated and better advised. We also know more about the adverse effects of taxation than 30 years ago. Therefore, it would not be desirable -- nor would it be possible -- simply to reinstate an earlier tax law that was not designed to deal with the more complex economy of the 1980s. But a useful perspective on the current need for tax reform and simplification can be gained by considering how the tax law -- and its impact on taxpayers -- has changed over the past three decades.

One important defect of the 1954 income tax was a schedule of marginal rates that reached 91 percent for a small number of taxpayers. Besides creating severe disincentives for saving, investment, and work effort, the confiscatory rates may have spawned many of the vexing tax avoidance schemes that now riddle the income tax. But the advantages of the earlier income tax were also manifest. Virtually all taxpayers below the top 10 percent of the income distribution paid tax at an essentially uniform marginal rate of about

20 percent. Only at the very top of the income distribution did rates become steeply progressive. The income tax was still being used primarily to raise public revenues, and not to guide households and private business enterprises into a multitude of activities -- some of dubious value -- through preferential tax treatment. With notable exceptions, the income tax was levied on a base that included most income. The erosion of that base by a multitude of exclusions, adjustments, deductions, and credits not required to measure income accurately had not reached its present stage.

Compared to today, the 1954 income tax was simpler, more neutral, and fairer, in many respects. Perhaps as importantly, it was probably seen to be fair by most taxpayers, and the perception of fairness helped maintain the voluntary compliance so crucial to the American system of taxation.

The Decline in Simplicity

In 1954 the income tax was simpler for most taxpayers, in part because incomes were lower and the financial affairs of most families were simpler. There was little need for most taxpayers to work through a variety of complicated forms -- and even more complicated instructions -- to determine eligibility for a particular tax benefit. Only 25 percent of taxpayers itemized deductions in 1955, compared to 35 percent in 1982. Thus, fewer taxpayers found it necessary to save receipts verifying a multitude of expenditures accorded tax-preferred status. There was also little need to engage the services of a tax professional to file an individual income tax return. Tax planning -- the rearrangement of one's economic affairs to minimize taxes -- was the concern of only a few. Most taxpayers did not even feel the need to consider the tax consequences of major decisions, much less everyday transactions.

Today the proliferation and expansion of exclusions, adjustments to income, deductions, and credits create a major burden of paperwork and make part-time bookkeepers of many Americans. At present, about 100 different Federal tax forms are used by individuals. Many decisions -- for example, whether and how to make a charitable contribution, whether to participate in insurance plans offered by an employer, and whether to contribute to a political party -- all have tax consequences. Ordinary citizens are confronted with the alternatives of using a professional tax preparer, becoming knowledgeable in arcane tax law, running afoul of the tax administration, or possibly passing up available tax benefits. Today, over 40 percent of all individual income tax returns -- and some 60 percent of all long forms (form 1040s) -- are prepared by paid professionals. So-called tax shelters, once known only to the wealthy, are now attracting increasing numbers of middle-income Americans, many of whom do not have access to sophisticated tax advice and are misled by the misrepresentations of unscrupulous promoters of illegal shelters, often with disastrous effects. Legislative response to the tax

shelter problem over the last 15 years has involved a patchwork of solutions that has generally increased the complexity of the tax system without correcting the underlying causes of tax shelters.

Erosion of the Tax Base

In 1954, the income tax did favor certain economic activities over others. For example, even then, tax experts criticized the fact that income from oil and gas properties, interest on state and local securities, and appreciation on capital assets were accorded preferential tax treatment. These "loopholes," as they were called, created inequities and distorted the use of the Nation's resources. By comparison, most interest, dividend, and labor income was taxed in full, and few forms of personal expenditure were tax deductible. The most important itemized deductions were for state and local taxes, charitable contributions, interest payments, and medical expenses; some of these had valid or easily understood justifications.

The last three decades have seen enormous erosion of the tax base. Compensation has increasingly taken the form of tax-free fringe benefits and legally taxable "perks" that many taxpayers improperly treat as tax-exempt. Interest on bonds issued by state and local governments has long been tax exempt, but recently these governments have increasingly used tax-exempt bonds to finance private investments. The investment tax credit greatly reduces the effective tax rate on income generated by business equipment, and accelerated depreciation and the deduction for interest expense combine to eliminate most taxes on income from debt-financed investments in real estate. In extreme cases these and other features of the tax law create losses for tax purposes that can be used to shelter other income. Exclusions, itemized deductions, and the deduction value of credits offset about 34 percent of personal income in 1982, as opposed to only 18 percent in 1954.

Economic Distortions

The lack of a comprehensive income tax base has two obvious and important adverse effects on the ability of the marketplace to allocate capital and labor to their most productive uses. First, the smaller the tax base, the higher tax rates must be to raise a given amount of revenue. High tax rates discourage saving and investment, stifle work effort, retard invention and innovation, encourage unproductive investment in tax shelters, and needlessly reduce the Nation's standard of living and growth rate.

Second, tax-preferred activities are favored relative to others, and tax law, rather than the market, becomes the primary force in determining how economic resources are used. Over the years, the tax system has come to exert a pervasive influence on the behavior of private decision-makers. The resulting tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lower productivity, lost production, and reduced consumer satisfaction.

The existing taxation of capital and business income is particularly non-neutral. It favors capital-intensive industries over others, such as services. The tax system favors industries that are unusually dependent on equipment over those -- such as wholesale and retail trade -- that rely more heavily on other forms of capital, including inventories and structures. High technology companies are put at a particular disadvantage. Since they do not require large capital investments that benefit from preferential tax treatment they bear the full brunt of high tax rates. A tax system that interferes less with market forces in the determination of what business should produce -- and how -- would be more conducive to productive investment and economic growth.

Inequities

Erosion of the tax base also creates inequities. Most obviously, it is unfair that two households with equal incomes should pay different amounts of tax, simply because one receives or spends its income in ways that are tax-preferred. There is, for example, no reason that employees should be allowed to escape tax on fringe benefits and entertainment provided by their employers, while others must buy the same benefits and entertainment with after-tax dollars. Even at moderate income levels, taxpayers with similar incomes can incur tax liabilities that differ by thousands of dollars. Moreover, gaps in the tax base create inequities across income classes, as well as within income classes. Some of the most important tax preferences -- those that give rise to tax shelters -- benefit primarily those with high incomes.

Unfair Treatment of the Family

Thirty years ago the personal exemption for the taxpayer, spouse, and each dependent was \$600, and there was a standard deduction of 10 percent of adjusted gross income, up to \$1,000. Thus a family of four would pay no tax until income exceeded \$2,675. Even though the personal exemption is now \$1,000 and a larger "zero-bracket amount" has replaced the standard deduction, inflation has resulted in a substantial decline in the real value of the "tax-free amount," the level of income at which tax is first paid. Some families with incomes below the poverty level have become subject to tax. Tax burdens have increased relatively more for large families with many dependents than for other taxpayers.

The tax law was designed for a society in which dependents are generally present as part of a family with both parents present. Some groups with greater-than-average proportions of poor families, such as the elderly and the disabled, receive special tax treatment, but this treatment is often arbitrary and random, and depends on the source of the income, not on the need of the family. Until recently, the working poor have almost always been excluded from such special treatment. The special burdens faced by many single heads of households -- especially those caring for dependents and trying to work at the same time -- have been addressed inadequately.

Inflation and the Income Tax

The U.S. income tax was not designed to be immune from inflation. Thus when inflation accelerated in the 1970s, taxpayers with constant real incomes were pushed into progressively higher tax brackets. The proportion of income paid to the government increased, even when real income did not, and higher tax rates created serious disincentives. Historically, "bracket creep," as this effect is called, could only be offset by periodic congressional action to increase the personal exemption, zero-bracket amount (ZBA), and bracket limits. But bracket creep sensitized the public to the problem of high and rising tax rates, and the Economic Recovery Tax Act of 1981 made a major step in tax reform by reducing tax rates and curing bracket creep. Even though many taxpayers are still subject to needlessly high marginal tax rates, the personal exemption, ZBA, and bracket limits will be indexed, starting in 1985. However, another important cause of inflation-induced tax increases remains uncorrected.

During inflationary times, taxes are collected on totally fictitious income. Capital gains taxes are paid when the prices of assets merely rise with inflation. Business firms are not allowed tax-free recovery of their real capital investments in inventories and depreciable assets. Moreover, high interest rates that merely reflect expected inflation overstate the real income of recipients of interest and inflate deductions for real interest expense.

The interaction of inflation and taxes creates further inequities and distortions. The overstatement of real interest income and deductions arbitrarily increases the tax burden on savers and rewards borrowers. Resource allocation is distorted by effective tax rates on some types of capital income that can easily exceed 100 percent. During the 1970s, the combination of high rates of inflation and a tax system that was not inflation-proof caused an increase in the tax-induced bias in favor of investment in owner-occupied housing; this probably aggravated the shortage of funds for business capital formation.

The combination of lower rates of inflation, the Accelerated Cost Recovery System of depreciation, and the lower tax rates on long-term capital gains have relieved some of the problem. Even so, the present tax system does not accurately measure real income from business or capital under most circumstances. Moreover, the tax treatment of business inventories and of debtors and creditors remains dependent on the rate of inflation.

The Rise of Tax Shelters

The well-advertised boom in the tax shelter industry in recent years has had particularly adverse effects. Some shelters involve little more than thinly veiled, if sophisticated, tax fraud. But even perfectly legal tax shelters distort the allocation of scarce capital because they produce highly visible inequities in taxation. Perhaps most importantly of all, they undermine taxpayer confidence in the

integrity and fairness of the tax system. Tax shelter losses typically result from a combination of current deductions for future expenses, deferral of taxable income, and conversion of ordinary income to preferentially taxed long-term capital gains. Thus, shelters allow taxpayers to defer tax liability far into the future. Tax deferral is equivalent to an interest-free loan from the Federal Government.

Recent data on tax returns of partnerships, a commonly used vehicle for tax shelters, indicate the nature and magnitude of the problem. In 1981 partnerships operating in the United States reported aggregate losses in excess of aggregate profits. This is not a cyclical phenomenon; partnership losses have increased steadily, relative to profits, for two decades. (See Figure 1-1.) Yet there is no reason to believe that Americans are losing more and more money each year by investing in these enterprises. Rather, many partnership investments are profitable on an after-tax basis, because they generate accounting losses that can be used to reduce or eliminate tax on other income (that is, to shelter other income from tax). But many shelter activities that offer attractive after-tax yields have little social value, as evidenced by before-tax yields that are low and sometimes even negative.

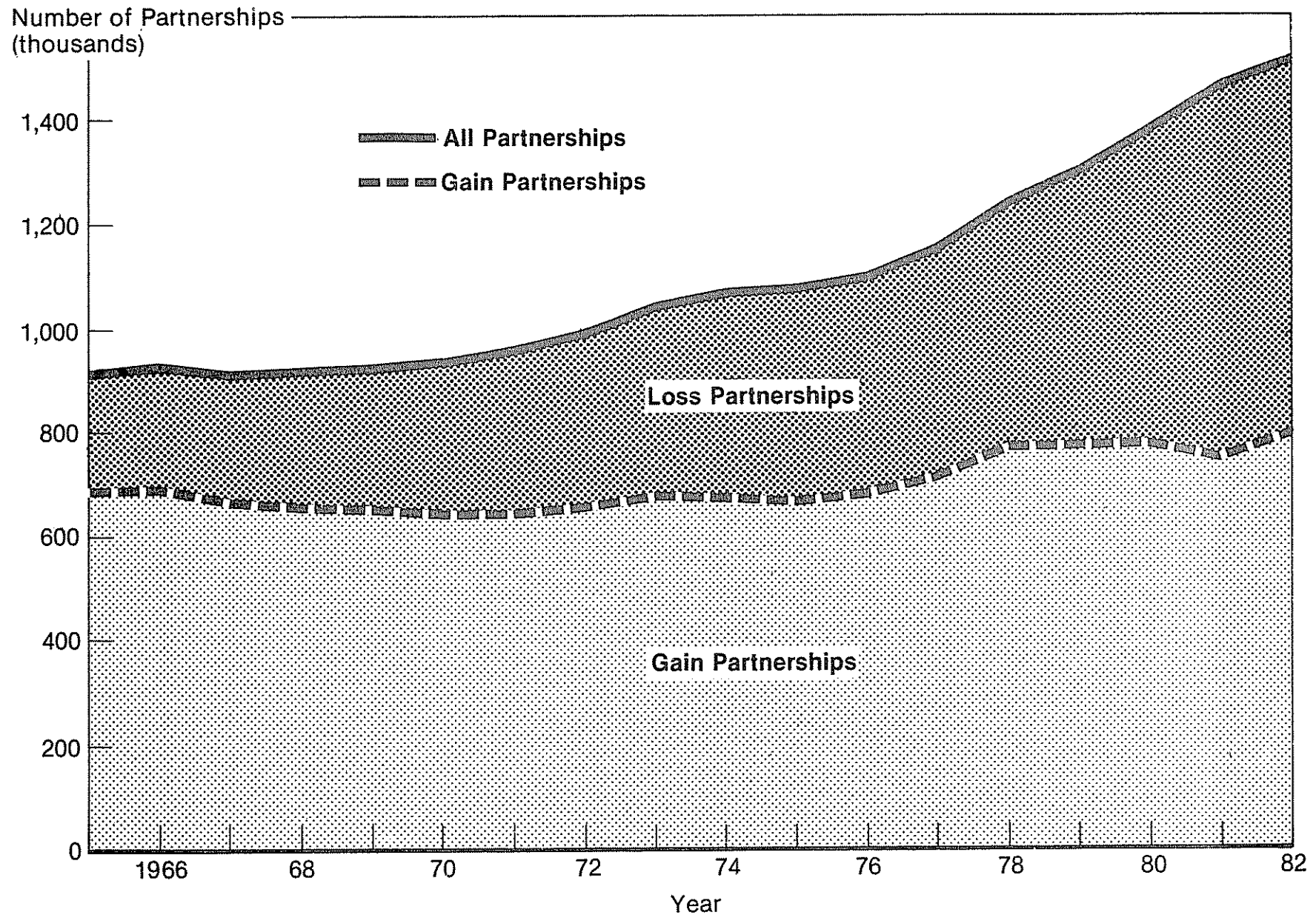
Partnerships in two industries that are favorites with tax shelter investors -- oil and gas and real estate -- are a case in point. In 1982, of the \$60 billion in aggregate losses reported by all partnerships, \$31.6 billion were attributable to losses reported by oil and gas and real estate partnerships, even though partnerships reporting losses in these two industries had a positive net cash flow of \$7.6 billion.

Between 1963 and 1982, the number of taxpayers who claimed partnership losses on their individual returns increased by 400 percent, from 412,000 to 2.1 million, even though the total number of individual tax returns filed during the same period increased by only 50 percent. As a result of this growth in tax shelter activity, there has been a significant erosion in the base of the Federal income tax, particularly among taxpayers with the highest incomes. In 1983, partnership losses claimed by individual taxpayers may have sheltered as much as \$35 billion of individual income from taxation. An estimated 82 percent of this total (\$28.6 billion in partnership losses) was reported by taxpayers whose gross income before losses was \$100,000 or more, and 60 percent (\$21.0 billion) was reported by taxpayers with gross income before losses in excess of \$250,000. By comparison, these groups reported 9 percent and 4 percent, respectively, of all gross income before losses reported by individuals.

A sample of taxpayer returns illustrates quite strikingly the way in which tax shelter accounting losses can be used to shelter substantial amounts of income from tax. A group of 88 taxpayers who held interests in certain non-abusive tax shelters -- shelters whose legitimacy was not being questioned by the Internal Revenue Service -- were chosen for statistical analysis. Though this sample was not

Figure 1-1

GROWTH IN PARTNERSHIPS, 1965—1982



selected scientifically, there is no reason to believe it is not representative; certainly it indicates the nature of the problem.

Taxpayers in this sample reported positive income -- that is gross income before losses -- of \$17 million, or an average of \$193,000. On average, each of these taxpayers owned interests in 6 partnerships, and a total of \$6.4 million in net partnership losses was reported on the 88 returns. When these losses are added to other business and investment-related losses of almost \$8.7 million, the taxpayers in the sample reported gross income of only \$1.9 million. Thus, accounting losses from tax shelter partnerships reduced the gross income of taxpayers in the sample by almost 40 percent, and other losses reduced income by an additional 49 percent. (See Table 1-1.) The taxable income of these individuals was further reduced by adjustments to gross income and by itemized deductions.

Of the 88 returns sampled, 19 returns, with an average gross income before loss (positive income) of \$243,710, reported a total income tax payment of \$500 or less; 37 returns, with an average gross income before loss of \$172,113 reported a total tax payment of \$6,000 or less. By comparison, a typical family of four, with positive income of \$45,000, but no tax shelter losses, would pay \$6,272 in taxes. The extent to which tax shelter losses can be used to dramatically reduce tax liabilities is further documented by estimates from the 1983 Treasury tax model which show that 9,000 taxpayers with gross incomes before losses of \$250,000 or more paid no tax as a direct result of partnership losses, while 59,000 taxpayers with that much positive income were able to reduce their tax payments by at least one-half.

The Decline in Taxpayer Morale

The United States has long been proud of the "taxpayer morale" of its citizens -- the willingness to pay voluntarily the income taxes necessary to finance government activities. Taxpayer morale ultimately depends, however, on the belief that taxes are fair. If the basis for this belief comes under suspicion, voluntary compliance with the tax laws is jeopardized. Thus, the perceived lack of fairness of the income tax may be as important as actual complexities, economic distortions, and inequities. Taxpayers resent paying substantially more tax than their neighbors who have equal or higher incomes. This is true even if the neighbor reduces taxes through commonly available and perfectly legal exclusions, adjustments, deductions, and credits, rather than by questionable or illegal means. Many witnesses at tax reform hearings the Treasury Department held throughout the country during June 1984 emphasized that tax should be collected on virtually all income, with little regard to how the income is earned or spent. Taxation can be thought to be unfair because the basic tax structure is defective, as well as because taxpayers who do not comply with the law are not penalized. The proliferation and publicity of tax shelters has a particularly pernicious effect on taxpayer morale.

Table 1-1

How Tax Shelter Losses Reduce Gross Income*

(Sample Of 88 Individual Income Tax Returns of Tax-Shelter Partners)

Gross Income Before Loss Class		: Number of Returns	: Total Gross Income Before Losses	: Total Net Partnership Losses	: Total Other Losses**	: Gross Income After Losses	
Less than \$60,000	22		\$ 590,435	\$ -278,805	\$ -120,136	\$ 191,494	
\$60,000 - \$100,000	20		1,634,839	-204,311	-260,361	1,170,166	
\$100,000 - \$200,000	17		2,499,210	-993,585	-709,124	796,502	
\$200,000 or more ...	19		<u>12,311,199</u>	<u>-4,667,042</u>	<u>-7,848,097</u>	<u>-203,940</u>	
Total	88		17,035,683	-6,143,743	-8,937,717	1,954,222	10
Average			\$ 193,587	\$ -69,815	\$ -101,565	\$ 22,207	

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Office of Tax Analysis

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* Calculations are from a sample of 88 individual income tax returns secured from four IRS Service Centers. Taxpayers filing these returns have investments in tax shelter partnerships that have previously been classified by an experienced examiner and accepted as nonabusive.

** Other losses include items such as nonpartnership business losses, partnership losses carried from prior tax years, and net capital losses.

Needed: Taxes That are Broad-Based, Simple, and Fair

Fundamental reform of the tax system is required to correct the problems just described. The tax system must be made simpler, more economically neutral, fairer, and more conducive to economic growth. These objectives are described more fully in the next chapter. The key to their achievement is to define real taxable income comprehensively, to exempt families with poverty-level incomes from tax, and to subject taxable income to a rate structure that, while mildly progressive, avoids rates so high that they stifle incentives and prevent economic growth. In short, the income tax should be broad-based, simple, and fair.